Payments Required to Obtain Regulatory Approval Did Not "Facilitate" Merger

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Twenty-five years after *INDOPCO, Inc.* [SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039], mergers and acquisitions are still raising subtle questions about capitalization. M&A expenses have no trouble meeting Code Sec. 162(a)'s lenient "ordinary and necessary" standard. But they may still face capitalization under Code Sec. 263(a).

Taxpayers must obviously capitalize the *price* they pay to acquire a trade or business, or an entity conducting a trade or business. Under Reg. §1.263(a)-5(a), taxpayers must also capitalize amounts paid to "facilitate" an acquisition. That sounds reasonable, but determining whether a particular expenditure "facilitates" a transaction can get tricky.

Payments to Obtain Regulatory Approval

The taxpayer in Chief Counsel Advice 201713010 (March 31, 2017) (the "CCA") was a corporation ("Acquirer") that had recently acquired Target in a merger. One of Target's subsidiaries ("Sub") was heavily regulated by state authorities. Acquirer and Target could not merge without the advance consent of Regulatory Board.

After several months of hearings and negotiations, Regulatory Board had approved the merger subject to four conditions:

1. Acquirer was required to make a substantial capital contribution to Sub, which Sub would use to provide its customers with a "rate credit."
2. Acquirer had to contribute to a "customer investment fund," which would provide Sub's customers with some long-term but redacted benefit.
3. Acquirer was to pay the state to pursue a development project that might provide Acquirer with a right to some kind of intangible property.
4. Sub had to commit to make specified annual contributions to local charitable organizations and to provide "traditional local community support."

Acquirer attempted to deduct the required payments under Code Sec. 162(a). On audit, the examining agent contended that the payments should have been capitalized as facilitative expenses under Reg. §1.263(a)-5(a). The matter was referred to the IRS National Office for its advice on whether Acquirer's payments had "facilitated" its acquisition of Target.

Causal Conundrums

Reg. §1.263(a)-5(b)(1) provides that an expenditure facilitates an acquisition if it is made "in the process of investigating or otherwise pursuing the transaction." Rather than attempt further definition, the regulations just say that determinations under this standard must be based on all the facts and circumstances. Somewhat more helpfully, the regulations state that the fact that an amount would not have been paid but for the transaction is "relevant," but "not determinative." [*Id.*]

The agent noted that Reg. §1.263(a)-5(e) treats certain acquisition expenses as facilitative only if they are incurred *after* the parties have signed a letter of intent or approved the essential terms of the transaction. But this taxpayer-friendly rule does not apply to "inherently facilitative amounts." This includes amounts paid for "obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings." [Reg. §1.263(a)-5(e)(2)(iv).]

The agent contended that Acquirer had made the required payments to obtain regulatory approval of the merger, which meant they were inherently facilitative. As facilitative payments, the agent reasoned, they had to be capitalized pursuant to Reg. §1.263(a)-5(a).

The National Office didn't see it that way. Reg. §1.263(a)-5(e)(2)(iv) says that obtaining regulatory approval **includes** preparing and reviewing regulatory filings. The CCA appears to have interpreted this as meaning that the regulation applies *only* to such expenses. According to the CCA, the costs of "preparing for and appearing before a regulatory board" are costs of obtaining regulatory approval. The costs of complying with the regulators' requirements are not.

The Direct Approach

The examining agent also tried a more direct approach. Even if the required payments were not *inherently* facilitative, weren't they still "facilitative" within the meaning of Reg. §1.263(a)-5(b)(1)? After all, if Acquirer made the payments in order to obtain regulatory approval of the merger, weren't they made "in the process of … pursuing the transaction"?

The CCA conceded that "it would not be unreasonable" to conclude that the required payments had been made to obtain regulatory approval for the merger. However, the CCA argued that the fact that certain costs would not have been incurred but for an acquisition does not establish that the costs facilitated the transaction.

The CCA invoked the preamble of the regulations [REG-125638-01, 67 FR 77,701, 77,706 (Dec. 19, 2002)], which introduced the concept of "facilitative costs":

> The facilitate standard is intended to be narrower in scope than a "but for" standard. Thus, some transaction costs that arguably are capital under a but-for standard, such as costs to downsize a workforce after a corporate merger (including

severance payments) or costs to integrate the operations of merged businesses, are not required to be capitalized under a facilitate standard. While such costs may not have been incurred but for the merger, the costs do not facilitate the merger itself.

As these examples suggest, discussions of the rejected "but-for" standard tend to concentrate on expenses incurred *as a result of* a transaction. When expenses are incurred *after* the merger, it is usually plausible to claim that they did not facilitate "the merger itself."

It is unclear from the CCA exactly when Acquirer made its required payments. But even if they were all paid after the merger closed, Acquirer obligated itself to make them *before* the transaction was approved. If Acquirer incurred this obligation for the purpose of obtaining regulatory approval, it is much easier to view the payments as facilitating the merger.

Under the regulations, the fact that an amount would not have been paid but for an acquisition does not establish that the payment facilitated the transaction. But what if the acquisition would not have occurred but for the *payment*? That fact cannot be treated as determinative, either.

According to the CCA, many of the required payments were "general operating costs" that Acquirer would have paid *anyway* as a normal part of conducting business. There would have been no reason to capitalize such operating expenditures, even if Acquirer had promised to make them. The fact that Regulatory Board would have blocked the merger if Acquirer had *refused* to make the payments should not change anything.

A Simpler Test?

In the end, the CCA appears to have reached its conclusion without recourse to causal arguments. In a heroic act of simplification, the CCA equated the regulations' term of art ("facilitative costs") with everyday "deal costs." Deal costs, according to the CCA, are the amounts that a taxpayer *pays to service providers* to investigate and execute transactions.

If this is the test, there is no need to split causal hairs. All we need to know is that the recipients of the required payments were not service providers working on the acquisition. Then it is immediately clear that Acquirer did not have to capitalize its payments under Reg. §1.263(a)-5(a).

Taxpayers cannot rely on a Chief Counsel Advice. But if CCA 201713010 reflects how the IRS *really* thinks about facilitative expenses, taxpayers will have a much easier time applying Reg. §1.263(a)-5(a). Assuming the CCA is not too good to be true, IRS should issue some official guidance to set the record straight.